mikephippsfinance

Finance Options.
Decision, decisions, decisions.

For most people the biggest decisions they make in life tend to revolve around marriage and family. The decision to be with someone for the rest of your life is a huge one and is often followed by a plethora of smaller decisions of apparent lesser consequence. For women it's things like the colour of the brides maids dresses, for blokes the brand of beer at the reception. The relationship rolls on and the blokes realise that leaving the toilet seat up is actually a life changing decision, and not necessarily a happy one!

So it is with finance.

Buying a management rights, motel or other accommodation asset is often the biggest financial decision the purchaser will ever make. As is often the case in life the initial decision is a big one but it is followed by a long list of micro decisions. Happily a wide range of lenders are keen to help but for good or bad the range of options can be a bit bewildering. I would argue that in spite of the occasional speed bump any industry that enjoys an embarrassment of riches in respect of finance options is in robust health so let's not get too concerned.

For me anyone borrowing money has two critical decisions to make in respect of structure. One is interest rates and the other is repayment terms. Just to complicate matters the two go hand in hand so I am going to tackle them together. Most borrowers I encounter are focused on interest only finance and that's fine provided you have a good reason for this strategy. Interest only for its own sake is no more advantageous than negative gearing without capital growth but that's a story for another day. Basically any interest costs that can be attributed to funds borrowed to generate taxable income can be claimed as a tax deduction. The received wisdom is that this is a good thing but it's not necessarily the case. If your average rate of tax is 30% then you are essentially spending a dollar in interest costs to save 30 cents. This strategy in isolation seems to make little sense. However, there may be good reasons to go down this path. The first and most obvious reason is cash flow management. Interest only commitments impact cash flow much less than paying off principal and interest. Particularly during the first year of ownership of your business I think it makes very good sense to opt for interest only finance. You are coming to terms with the cash flow cycle of the business, managing any little surprises and replenishing working capital and contingency savings after the purchase. Makes sense to keep your debt servicing commitments to a minimum.

After allowing for operational cash flow the other reason you might want to stay on interest only terms over the medium term is simply better options for the money you would otherwise use to pay down principal. The most common strategy we see adopted is using these funds to make contributions to superannuation or to make other investments outside of the business. Again, provided these investments deliver a return that compensates for the interest cost penalty of not paying principal I think this makes perfect sense. As luck would have it so do the banks. When we ask for further interest only terms after the initial period and we can articulate our clients investment strategy the result is usually positive. Of course, if interest only terms are required simply because the borrower can't afford P and I then there is no hope of an approval in the first place.

On to interest rates. For most borrowers that's a simple decision between fixed and variable options. At present we have almost no clients fixing rates so the general view seems to be that rates will stay low for some time yet. Of course, by the time there is clear economic evidence that rates may rise the fixed rate horse will have bolted so best to make a pre-emptive strike if you like the idea of a fixed rate.
Borrowers do have the option of starting on a variable rate and fixing all or part of their loan down the track. Bank fees associated with this sort of change are minimal and for some it's a fall back option to keep in mind. Variable rates do have one big advantage over fixed rates. In nearly all cases you can pay off a variable rate loan as fast as you like without penalties. Fix your rate and whatever repayment arrangements you have are pretty much what you are stuck with. Penalties will apply if you pay extra or if you pay the loan out during the fixed rate period. We recommend to all our clients to think about cash flow, debt reduction and the ultimate plans for the asset before fixing interest rates.
So why not have your cake and eat it too.

My personal preferred option at present when borrowing money for business and investment purposes is interest only variable rate funding. My finance contract commitment is to pay the interest each month while my options are to pay as much extra as I like and to get back the extra any time I please. Banks don't charge penalties for paying down variable rate interest only loans and nearly all loan products have redraw features. I only pay interest on the actual loan balance and I can hammer the debt with any available cash that I have no immediate plans to spend. If I need some of the money back I simply redraw it via Internet banking or for larger amounts at my local bank branch. It's a great way to provision for future tax commitments or to simply build up a war chest for future investments.

As with all great strategies there is one small catch. If you pay down tax deductible debt and then redraw you need to be able to show the tax man that you used the redrawn funds for business or investment purposes. If you use the redrawn funds for personal reasons it may be ruled that those redrawn funds which form part of your loan balance are not tax deductible in terms of the proportioned interest costs. If in doubt consult your accountant.

A couple of final points. Pay off non tax deductible debt first and fast. Only the bank and your finance broker make money if you leave non tax deductible debt on interest only. Get rid of it as fast as you can!
Lastly, I am not an economist, financial planner or clairvoyant. Borrowers should consult their accountant regularly, review their financing arrangements annually and keep abreast of economic news. Interest rates and bank credit policies can and will change from time to time. The best you can hope for is that you will make decisions on an informed basis and be happy to live with the outcomes.

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